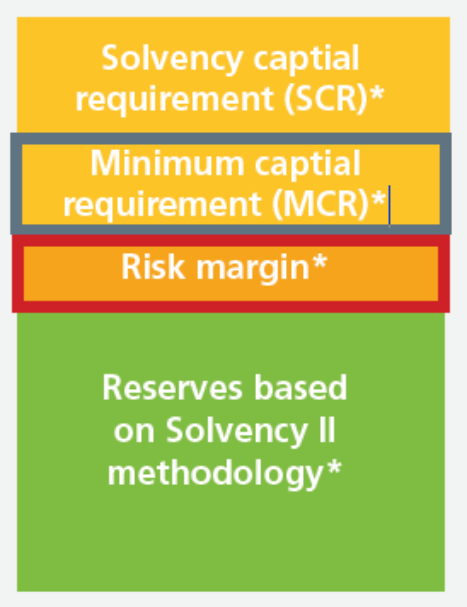
Risk margin

Engagement pack

The current risk margin is too high and too volatile

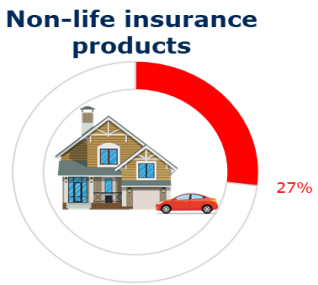


What is the risk margin?

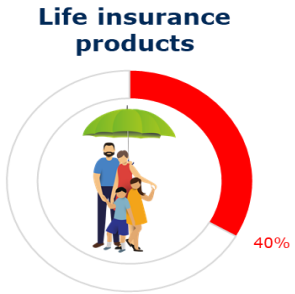
- It is a layer of capital insurers must hold on top of both the reserves needed to cover all expected claims and expenses and the solvency capital required to cover all risks
- It is an additional theoretical amount of capital meant to enable an insurer's policies to be transferred in the very unlikely event of an insolvency

The current risk margin is far too high and volatile

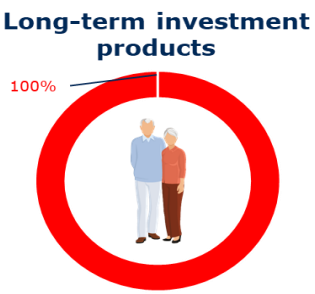
- It ties up around €190bn of insurers capital and significantly reduces insurers capacity to take on risks and invest in the economy
- It is also a significant and inappropriate source of balance sheet volatility



Risk margin is **27% of SCR** on average



Risk margin is **40% of SCR** on average



Risk margin can be **in excess of 100% of SCR**

Source: Insurance Europe

EIOPA's proposed changes do not go far enough

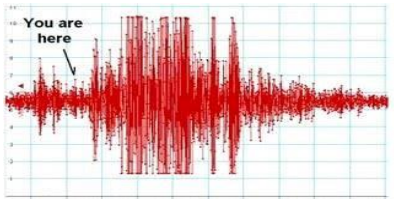
- The cost-of-capital rate used is too high
- The lambda parameter and floor are too high
- There is no allowance for diversification

Correcting for these flaws could release more than €100bn of capital that will ultimately serve society and the economy better

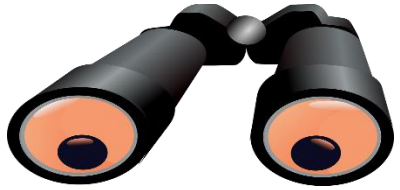
The Solvency II cost-of-capital rate is too high

- One of the key inputs for the risk margin calculation is the Solvency II cost-of-capital rate – the return that investors are assumed to require in order to provide capital to support pure insurance risks arising from their policies
- There are **a number of flaws** in EIOPA's derivation of this which mean that it is **too high and inconsistent with Solvency II specifications:**

It uses the wrong assumptions: It does not reflect the capital structure of insurance companies (assuming only equity funding and ignoring bond financing)



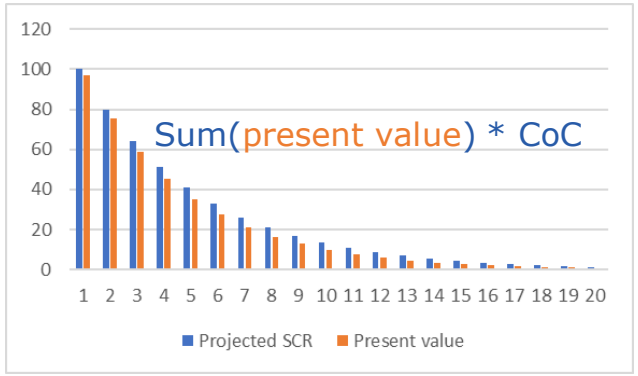
It incorrectly captures asset risk: It reflects more than pure insurance risks (in particular, risky assets and new business risks – both of which are ruled out by SII regulations)



It is backward, not forward looking: The methodology for deriving it is backward-looking (and hence is biased upwards) – forward-looking estimates are more consistent with both SII regulations and a range of expert studies

The cost-of-capital rate should be forward-looking and reflect pure insurance risk only as well as the funding structure of insurance companies

The lambda parameter and floor are too high



How is the risk margin calculated?

- The risk margin is equal to the present value (i.e. value in today's terms) of future projected capital requirements, multiplied by the cost-of-capital rate (CoC)

EIOPA proposal

- EIOPA have proposed the following variation of the CROF proposal above in the March 2020 holistic impact assessment:

$$RM = CoC \cdot \sum_{t \geq 0} \frac{SCR(t) \cdot max(\lambda^t, 0.5)}{\left(1 + r(t+1)\right)^{t+1}}$$

- The introduction of the time-dependent lambda parameter allows for a reduction of the volatility of the present value of future projected SCRs and for risk dependence over time to be considered

However…

- The proposed value of 0.975 for lambda is too high and does not appropriately reflect the evolution of risks over time
- The imposition of an arbitrary floor of 0.5 has not been justified and reduces the effectiveness of the proposal to reduce balance sheet volatility.

The risk margin should allow for diversification at group level

- Diversification is the key fundamental principle of insurance – by spreading risks across products and policies, insurers can offer policyholders peace of mind and fulfill an essential public need

Diversification is allowed for in calculating capital requirements…

- This is recognised in the SII regulations, which explicitly recognise diversification for the purpose of calculating capital requirements

and local entity risk margin calculations…

- This is also recognised for the risk margin at local entity level, where the risk margin (which is based on capital requirements) permits diversification between risks in its calculation

but NOT group risk margin calculations…

- However, **counter-intuitively**, diversification between risks at **group level** is **not** permitted when calculating the risk margin
- This contrasts with other areas of the Solvency II text and practical experience – where there are many examples where groups have transferred its policies as a whole

The risk margin calculation should recognise the fundamental principle of insurance and recognise diversification at group level

Appendix: a history of risk margin developments

- By industry consent, the risk margin is far too high and too volatile, and work undertaken by the CRO Forum ("CROF") as far back as 2008 has supported this view*. In addition, over recent years large reductions in interest rates have resulted in large increases in the risk margin, highlighting further the excessive size and volatility of the risk margin

- As part of the 2018 Solvency II Standard Formula review EIOPA reviewed the Risk Margin cost-of-capital rate. The CROF put forward a number of arguments supporting a reduction in the CoC rate from the current 6% to 3%, a position which was supported across industry. In its final advice to the Commission however, EIOPA proposed no change to the CoC rate and so this was left unchanged

- During the initial consultation phase of the 2020 Solvency II review, EIOPA introduced the lambda parameter in its March 2020 holistic impact assessment exercise, together with the floor

- While EIOPA's introduction of the lambda parameter and acknowledgement that the risk margin is too high and volatile, particularly for long-term business, is a positive development, the magnitude of the proposed change is not sufficient to address the issues around the risk margin's excessive size and volatility

Change in the risk margin is long overdue – i.e. no delay/phasing in should be considered

* "Market Value of Liabilities for Insurance Firms", July 2008.